

Internal Revenue Service
memorandum

CC:INTL-249-86
Brl:GMSellinger

date: JUN 18 1986

to: James F. Kidd, Special Trial Attorney CC:CHI
District Counsel, Chicago

from: Senior Technician Reviewer, Branch 1 CC:INTL:1
Associate Chief Counsel (International)

subject: [REDACTED]

This refers to your memorandum of April 24, 1986, with respect to the above case which is currently pending in the United States Tax Court for the years [REDACTED] and [REDACTED].

ISSUE

Whether section 6621(d) of the Code, which imposes additional interest on substantial underpayments attributable to tax motivated transactions, may be applicable to an underpayment arising from the Service's section 482 allocation based on the petitioner paying its subsidiary substantially greater than an arm's-length price for certain goods which the subsidiary corporation manufactured for the parent.. 6621.00-00.

CONCLUSION

Section 6621(d) of the Code may be applicable to an underpayment caused by a section 482 allocation where an overvaluation of 150 percent or more is present.

FACTS

Based on the information provided in your proposed amendment to answer, the petitioner, [REDACTED], engaged its wholly-owned subsidiary, [REDACTED] ([REDACTED]) during the years [REDACTED] and [REDACTED] to perform manufacturing services with respect to the production and manufacture of a variety of parts pertaining to a type of [REDACTED] manufactured by petitioner called a "[REDACTED]" ([REDACTED]). The work performed by [REDACTED] with respect to the [REDACTED] parts fell into the following three general categories:

- (1) The manufacture of partially finished goods to completion (finishing work);

008198

- (2) Work done to manufacture parts to a state of partial completion (intermediate work); and
- (3) Manufacture of raw materials into completed parts (complete manufacture).

Regardless of the level or quantity of work actually performed by [REDACTED], petitioner in all instances paid to [REDACTED] with respect to the parts the amount reflected in petitioner's published [REDACTED], less [REDACTED] percent. The amounts in petitioner's [REDACTED] are the published catalogue prices at which spare parts were available for sale to any users of [REDACTED]'s manufactured by petitioner. The price paid to [REDACTED] by petitioner was in no way connected to the level or amount of work actually performed by [REDACTED]. Petitioner paid the same reduced list price to [REDACTED] regardless of whether [REDACTED] performed finishing work, intermediate work or complete manufacture. The price paid to [REDACTED] in [REDACTED] the year in which [REDACTED] was beginning operations, amounted to [REDACTED]'s cost of manufacturing plus [REDACTED] percent. The price paid by petitioner to [REDACTED] in [REDACTED] amounted to [REDACTED]'s cost of manufacturing plus [REDACTED] percent. It is our position that the correct arm's-length price to [REDACTED] for the work performed does not exceed [REDACTED]'s manufacturing cost plus [REDACTED] percent, as determined in the notice of deficiency. The price paid to [REDACTED] for the work described above, the arm's-length price determined by respondent, and the percentage by which petitioner's determined value was overstated is shown below:

<u>Year</u>	<u>Price Paid</u>	<u>Arm's-Length Price</u>	<u>Percentage Overvaluation</u>
[REDACTED]	\$ [REDACTED]	\$ [REDACTED]	[REDACTED] %

In view of the above information, the question presented is whether the [REDACTED] percent overvaluation in [REDACTED] and the [REDACTED] percent overvaluation for the year [REDACTED] makes the petitioner subject to the higher rate of interest on substantial underpayments attributable to tax motivated transactions as set forth in § 6621(d)(3) of the Code.

LEGAL ANALYSIS

Section 6621(d)(1) of the Code provides as follows:

(1) In general. - In the case of interest payable under § 6601 with respect to any substantial underpayment attributable to tax motivated transactions, the annual rate of interest established under this section shall be 120 percent of the adjusted rate established under subsection (b).

Section 6621(d)(3) defines tax motivated transactions as including but not limited to "any valuation overstatement within the meaning of section 6659(c). Section 6621(d) was added to the Code by section 144(a) of the Tax Reform Act of 1984, effective for interest accruing after December 31, 1984, regardless of the year of the transaction. On the other hand the addition to tax, in an amount equal to 10 to 30 percent of the underpayment, found in section 6659 of the Code was added to the Code by section 722 of the Economic Recovery Act of 1981, effective for returns filed after December 31, 1981. Thus in the instant case additional interest under section 6621(d) may be sought, but because the returns in question were filed prior to 1982, the 6659 penalty is inapplicable. See, e.g. Slowiejczyk v. Commissioner, 85 T.C. 552 (1985).

The legislative history does little to clarify whether Congress sought in any way to restrict the types of transactions to which the definition of an overvaluation found in section 6659(c), would apply. If any conclusion may be drawn it is probably that the definition of an overvaluation is to be read expansively. The staff of the Joint Committee on Taxation noted that there were about 500,000 tax disputes outstanding which involved property valuation questions of more than routine significance. These cases alone involved approximately \$2.5 billion in tax attributable to the valuation issues. Congress recognized that valuation issues frequently involve difficult questions of fact. Often these issues seem to be resolved simply by dividing the difference in the values asserted by the Internal Revenue Service and those claimed by the taxpayer. Because of this approach to valuation questions, Congress believed that taxpayers were encouraged to overvalue certain types of property and to delay the resolution of valuation issues. Since the tax interest rate under prior law had been below the prevailing cost of borrowing this tendency probably was accentuated somewhat. See: General Explanation of the Economic Recovery Act of 1981 prepared by the Staff of the Joint Committee on Taxation, p. 332 (Dec. 29, 1981). Accordingly it would appear that Congress intended to reach all types of gross overvaluations so as to discourage taxpayers from intentionally overvaluing their property and taking their chances of being audited by the Service. As of this date there are no proposed or final regulations and scant case law which shed additional light on the section 6659(c) definition of a valuation overstatement.

In enacting section 6621(d) of the Code to provide for an increased rate of interest for tax motivated transactions Congress showed concern over the continued rise in the backlog of cases that involved tax shelter issues. It was to reduce the backlog of these cases, especially in the Tax Court, that Congress enacted section 6621(d) so that the taxpayers would no longer have the incentive to delay the final disposition of their cases. However, it is also clear that section 6621(d) additional interest on underpayments attributable to tax motivated transactions was to apply to all valuation overstatements that came within the section

6659(c) definition. See: General Explanation of the Tax Reform Act of 1984 prepared by the Staff of the Joint Committee on Taxation, p. 485 (Dec. 31, 1984). Additionally, section 6659(f) imposes a more stringent test for charitable contributions for purposes of the addition to tax, and not all such overvaluations are typically thought of as traditional tax shelters. Thus, although Congress specifically intended to reach tax shelters, the language of the statute is very broad and clearly reaches the facts of the instant case. Here, if the Commissioner is sustained on the underlying section 482 adjustment there would be an overstatement of the value of property, and that overstated property valuation would be claimed on a return in the form of the taxpayer's overstatement of its cost of goods sold. Furthermore, if the I.R.S. is sustained, such overvaluation would be [REDACTED] percent or more of the amount determined to be correct. Accordingly, while Congress may have not specifically contemplated overvaluations giving rise to section 482 adjustments to also give rise to the addition to interest found in section 6621(d) of the Code since very few section 482 overvaluations are that egregious, nevertheless, the language of section 6621(d) is applicable and in our opinion additional interest should be asserted in the instant case.^{1/}

If you have any inquiries please contact, George M. Sellinger on FTS 566-5862.


GEORGE M. SELLINGER

^{1/} It is interesting to note that sections 6621 and 6659 could be defeated by the parties in a section 482 context if the parties merely undervalued goods or services traveling away from the U.S. taxpayer. However, merely because sections 6621 and 6659 would not be adequate to deal with all section 482 cases does not mean that they should not be applied when appropriate.